

those that an unregulated firm would face in competitive markets where proportionate reductions in costs across services would—all else equal—result in proportionate reductions in service prices. Similarly, the asymmetric treatment of errors that resulted in a cap higher than otherwise allowed, and those that lead to a cap lower than otherwise allowed would change the risk that the regulated firm faces when it is required to calculate parameters of the price cap plan for long periods of time with no explicit directions beyond general principles.

16. In addition, the fact that the price cap plan parameters are subject to regulatory change—as long as four years after the fact—increases the regulatory risk in a price cap plan that was intended to reduce regulatory uncertainty. In unregulated, competitive markets, firms believe that actions they take to increase productivity growth will result in higher profits, and accordingly they risk their capital and effort in the expectation that they will be rewarded if they are successful in the market. In theory, price-cap regulated firms face similar incentives because increased productivity growth leads to higher earnings, provided only that the higher earnings are not achieved by increasing prices above the amount allowed by the various price cap indices. If the rules of the price cap plan change in mid-stream, firms will no longer treat the parameters of the plan as fixed and attempt to maximize profits. As observed in the economic literature on incentive regulation

(i)f large financial rewards and penalties are linked to performance measures over which the [regulated] firm has relatively little control, the firm will be exposed to substantial risk, and corresponding gains from improved incentives will be minimal.¹¹

Ultimately, it is the belief of the regulated firm that the deck is not stacked and that increased productivity will lead to increased profits that generates the improved performance associated with price cap regulation. Regulatory decisions that undermine those beliefs threaten the benefits that customers expected to receive from adoption of price cap regulation.

¹¹ D. Sappington and D. Weisman, *Designing Incentive Regulation for Communications Transfers*, Cambridge MIT Press, 1996, p. 334.

B. Performing only a partial calculation would not compensate customers for overcharges.

17. According to the *1993-96 Access Tariff Order*, the refund liability “must compensate customers for overcharges incurred during the course of this investigation.” (at ¶104). Thus, if no customer paid more than if Bell Atlantic had allocated its sharing obligation in accordance with the *1993-96 Access Tariff Order*, then no customer suffered damages and there is no refund liability. This standard is consistent with the incentive structure of the FCC’s price cap plan, where the firm is left free to set prices wherever it can, provided that various price ceilings (the PCI, SBIs, and the maximum CCL) are respected. Only when the actual API exceeds the PCI recalculated in accordance with the *1993-96 Access Tariff Order*—or when an actual SBI or CCL rate exceeds the recalculated maximum SBI or CCL rate—would a customer have paid more than it would have if Bell Atlantic allocated its earnings sharing adjustment according to the new Order. Hence, the refund obligation should compare what customers were charged relative to the maximum that they would have been charged had Bell Atlantic calculated its sharing adjustment as required in the *1993-96 Access Tariff Order*.

18. The result of that calculation can be positive or negative in any basket, and, in aggregate, customers of interstate services were not overcharged at all. The correct amount of earnings sharing adjustment was calculated and returned to customers through reductions in the PCIs, SBIs and CCL rates over all four baskets in every year. If the allocation had been done in accordance with the *1993-96 Access Tariff Order*, the allocation across baskets would have been different in each year, but the total amount returned to customers would have remained the same as was actually returned to customers in each year.

C. The proposed method of calculation is incomplete and incorrect.

19. Performing only the partial calculation set out in the *1993-96 Access Tariff Order* would not calculate the amount by which customers were overcharged, including interest. First, even focusing only on the Common Line Basket, there appears to be double-counting in the overcharge calculation which simply sums the overcharges associated with the PCIs, SBIs and the maximum CCL rate as if these price limits were independent. Suppose one rate element for

example, the CCL—were incorrectly priced too high so that, in addition, both the API and an SBI exceeded its corresponding PCI and SBI upper bound. The amount by which a customer was overcharged is the excess revenue from the overpriced CCL rate element, not the sum of the revenues associated with the excess API, SBI and maximum CCL rate.

20. Second, performing only the partial calculation—that is if the offsetting undercharges were ignored—would force Bell Atlantic to share more than the amount required in the price cap plan. This not only would be inconsistent with the Commission's own rules, but it would be unwise economic policy since it would undermine the very incentives price caps were designed to create.

21. Third, if total common line revenue were used to allocate the earnings sharing adjustment, switched access price limits would fall by a greater percentage than special access or interexchange price limits, despite the assumption in the *1992 Access Tariff Order* that earnings derive from all interstate services and thus that all interstate service costs have fallen proportionately, and price limits should follow proportionately.

IV. PERMANENT CHANGES TO CORRECT PRICE LIMITS ARE UNNECESSARY.

22. Unlike some of the other investigation issues resolved in the *1993-96 Access Tariff Order*, a misallocation of the earnings sharing adjustment has no permanent effect on price limits. Since each exogenous adjustment to implement sharing is effectively removed at the next annual filing, any error in Bell Atlantic's PCIs (and other pricing limits) lasts only one year.¹² Thus if it were determined that Bell Atlantic's allocation of sharing adjustments were incorrect in every year, no change would be required to the calculations of Bell Atlantic's PCIs, SBIs and maximum CCLs to become effective June 30, 1997. The (incorrect) adjustments made in June 1996 must be reversed—as they would be absent the *1993-96 Access Tariff Order*—and the new exogenous adjustment for sharing (if any) must be allocated across the price cap baskets in accordance with

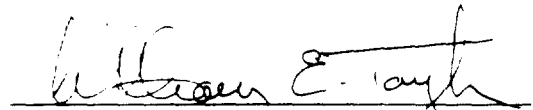
¹² Thus any error in the 1993 filing affects the July 1993 and January 1994 PCIs but not the July 1994 (and future) PCIs. Similarly, errors in the 1994 filing have no effect on the PCIs on or after July 1995, etc.

the current *1993-96 Access Tariff Order*, but for these particular errors it is not the case that "an uncorrected error in one year's PCI causes an error in next year's PCI."¹³ Thus the calculations in Subsection B of the *1993-96 Access Tariff Order* are unnecessary to reset the 1997 PCIs, SBIs and maximum CCL to make them consistent with "what would have been in place had they been calculated consistent with the Commissions rules and decisions."

V. CONCLUSIONS

23. Requiring Bell Atlantic to overcompensate interstate customers for overcharges in one basket without offsetting against that compensation undercharges in other baskets would expose Bell Atlantic to a level of sharing beyond that set out in the price cap plan. Changing price cap rules in mid-stream would expose all price-cap regulated firms to additional regulatory risk which would reduce the improvement in incentives that price cap regulation was intended to produce. The Commission should confine the refund from Bell Atlantic's allocation of the earnings sharing adjustment to the overcharges that interstate customers actually paid (including interest), netting out the overcharges in the common line basket against the undercharges in the traffic sensitive, special access and interexchange baskets.

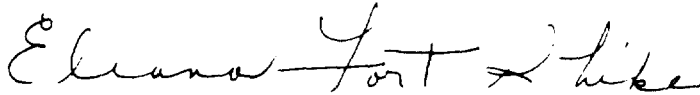
¹³ *1993-96 Access Tariff Order* at ¶ 97, footnote 22.



William E. Taylor

Subscribed and sworn to before me this

16th day of May, 1997.



Notary Public

My commission expires

ELEANOR FORT SHIKE
Notary Public, State of New York
No. 31-8974420
Qualified in New York County
Commission Expires March 30, 1998

EXHIBIT 2

WELL ATLANTIC TRANSMITTAL NO. 777
 RECULATION OF EARNING DISTRIBUTION

APPENDIX C
 PAGE 1 OF 3

	SOURCE	COMMON LINE	TRAFFIC SENSITIVE	TRUCKING	INTER EXCHANGE	TOTAL (U) - (A + B + C + D)
1. 1993 Annual Budget	Trans. 777, TRP, PCL - 1	(A) 1,345,342,722	(U) 316,338,550	(C) 921,355,336	(B) 137,567,909	(U) - (A + B + C + D) 2,920,804,717
2. Distribution of Revenue	Line 1 Current Col. A Line 1 Col. B	46,060,715	17,684,818	31,344,617	4,709,911	100,000,000
3. 1994 Sharing Process	Line 2 Current Col. * WP 8 57 Line 2	(1,889,409)	(725,431)	(1,297,959)	(193,201)	(4,101,000)
4. 1994 Back	Line 2 Current Col. * WP 8 57 Line 3	(8,031,402)	(3,081,699)	(5,500,420)	(821,271)	(17,431,000)
5. 1994 Sharing	Line 2 Current Col. * WP 8 57 Line 1	(12,678,215)	(12,346,660)	(12,179,617)	(1,341,504)	(10,946,000)
6. 1994 Total Sharing - Calculated	Sum Line 3 - Line 5	(42,599,226)	(16,355,790)	(29,174,003)	(4,355,980)	(92,485,000)
7. 1994 Total Sharing - Filled	Trans. 777, WP 8 57-4, Line 6	(20,920,112)	(23,163,608)	(41,852,298)	(6,248,982)	(92,485,000)
8. Difference	Line 6 - Line 7	(21,679,114)	7,107,818	12,678,295	1,891,002	0

1995 Annual Access Tariff
 Petition of AT&T Corp.
 (filed May 30, 1995)

LL ATLANTIC RECALCULATION OF SHARING DISTRIBUTION

	SOURCE	COMMON LINE (A)	TRAFFIC SENSITIVE (B)	TRUNKING (C)	INTER- EXCHANGE (D)	TOTAL (E)
1996 Annual Filing R Distribution of Revenues	Tran. 867, TRP, PCI-1 Line 1/Line 1 Col. E.	1,284,822,584 45.816%	482,983,648 17.223%	924,395,618 32.963%	112,123,129 3.998%	2,804,324,959
1995 Sharing - Dist. Calc.	Line 2*Total Sharing Col E	(13,541,762)	(5,090,547)	(9,742,937)	(1,181,754)	(29,557,000)
1995 Sharing - Filed	T867, WP 8-53-4, Line 5+6	(5,540,143)	(7,628,889)	(14,601,140)	(1,786,817)	(29,558,989)
Difference	Line 6 - Line 7	(8,001,619)	2,538,342	4,858,203	605,083	(11)

CIFIC BELL RECALCULATION OF SHARING DISTRIBUTION

	SOURCE	COMMON LINE (A)	TRAFFIC SENSITIVE (B)	TRUNKING (C)	INTER- EXCHANGE (D)	TOTAL (E)
1996 Annual Filing R Distribution of Revenues	Tran. 1864, TRP, PCI-1 Line 1/Line 1 Col. E.	888,523,273 53.796%	304,871,174 18.459%	458,103,178 27.736%	142,620 0.009%	1,651,840,243
1995 Sharing - Dist. Calc.	Line 2*Total Sharing Col E	(17,855,594)	(6,126,633)	(9,205,954)	(2,866)	(33,191,046)
1995 Sharing - Filed	T1864, WPIIC-11	(7,278,386)	(10,781,259)	(15,067,042)	(64,359)	(33,191,046)
Difference	Line 6 - Line 7	(10,577,208)	4,654,626	5,861,088	61,493	-

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(filed Apr. 29, 1996)

APPENDIX C
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ATLANTIC TRANSMITTAL 644

ALLOCATION OF SHARING DISTRIBUTION

SOURCE	COMMON LINE (A)	TRAFFIC SENSITIVE (B)	TRUNKING (C)	INTER EXCHANGE (D)	TOTAL E= (A+B+C+D)
1993 INTER-LATE REVENUES	Note 1 1,336,208,040	485,937,801	853,077,223	142,438,351	2,817,661,415
DISTRIBUTION FACTOR	Ln1 Col/Ln1 ColE 0.474226	0.172461	0.302761	0.050552	
1994 SHARING DISTRIBUTION	Ln1*Ln2 (28,404,235)	(10,329,747)	(18,134,157)	(3,027,861)	(59,896,000)
REVENUES OWNED BY BELL ATLANTIC	WP 8-53-4 478,858,233	485,937,042	853,077,223	142,238,351	1,960,110,849
BELL ATLANTIC DISTRIBUTION FACTOR	WP 8-53-4 0.2443	0.2479	0.4352	0.0726	
BELL ATLANTIC SHARING DISTRIBUTION	Ln3 Ln6 (14,632,689)	(14,848,999)	(26,067,869)	(4,346,442)	(59,895,000)
DIFFERENCE		4,519,252	7,933,712	1,318,581	(1)

- e 1: Line 1, Col A - 1993 base period R(t-1) Revenues from Bell Atlantic Transmittal 644, TRP PCL 1 Chart.
- e 2: Line 3, Col E - 1994 Total Sharing as reported by Bell Atlantic Transmittal 644, Workpaper 8-53-1.

1994 Annual Access Tariff
Petition of AT&T Corp.
(filed Apr. 26, 1994)

sharing amount properly among that carrier's service baskets, by omitting end user line charges from the Common Line basket's revenues, despite the Commission's finding in the 1992 Tariff Order that sharing should be allocated in proportion to basket revenues.⁵⁷ The effect of this misallocation was to understate the sharing amount and, hence, overstate Bell Atlantic's rates in the Common Line basket by almost \$1.9 million.⁵⁸

The June 23 Order (9 48), agreed with AT&T that this procedure raised questions concerning the validity of Bell Atlantic's price cap adjustments, and required Bell Atlantic to justify its sharing allocation methodology.

⁵⁷ 1992 Tariff Order, 7 FCC Rcd. at 4730-33.

⁵⁸ This allocation methodology also correspondingly overstated the sharing amounts, and understated the access rates, for Bell Atlantic's other baskets. The sharing amounts as filed by Bell Atlantic, and as corrected to reflect the inclusion of end user revenues in the allocation process, are as follows:

Basket	As filed	Percent	Corrected	Percent
	Amount \$ mil		Amount \$ mil	
Common Line	\$1.749	11.0	\$3.606	11.4
Traffic Sensitive	\$4.099	51.0	\$3.093	37.1
Special Access	\$1.861	11.0	\$1.118	14.3
Interexchange	\$1.400	7.0	\$1.400	8.2

1993 Annual Access Tar.
AT&T Opposition to Dire
Cases
(Filed Aug. 24, 1993)

EXHIBIT 3



IMPACT OF PARTIAL CORRECTION BY REDISTRIBUTING SHARING TO COMMON LINE BASKET ONLY
(Dollars)

LN	ITEM	SOURCE	(A) Amount Shared in 1993 Access Tariff	(B) Amount Shared in 1994 Access Tariff	(C) Amount Shared in 1995 Access Tariff	(D) Amount Shared in 1996 Access Tariff
1	Total 50% Tariff Sharing	Total Amount Shared (based on 50% of prior years' earnings above 12.25%) Note 1	(2,025,000)	(60,668,000)	(9,149,500)	(24,910)
2	Impact of Sharing Redistribution on Common Line	Amended 1997 TRP Ln 9 WP S 1, S 2, S-3 and S 4	0	(11,951,097)	(2,167,114)	(20,267)
3	Adjusted Sharing with Redistribution to CL Basket Only	Ln 1 + Ln 2	(2,025,000)	(72,619,097)	(11,316,614)	(45,177)
4	Percent Increase in Sharing with Redistribution to CL Basket Only	(Ln 3 - Ln 1) / Ln 1	0.00%	1,186.00%	23.30%	2.10%
5	Effective Sharing on Earnings above 12.25%	Ln 3 - (Ln 1 * 2) - Note 2	50,000%	63.53%	10.17%	63.53%

Note 1

Column A from BA Transmittal No. 568 A WP 8 52 D

Column B from BA Transmittal No. 644 WP 8 53 4

Column C from BA Transmittal No. 777 WP 8 57 4

Column D from BA Transmittal No. 867 WP 8 53 4

Note 2

Line 5 amounts reflect the proportion of earnings above 12.25% that would effectively be shared if sharing redistribution is applied to Common Line Basket only